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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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In the Matter of	
Price Cap Performance Review for Local Exchange Carriers	CC Docket No. 94-1
Access Charge Reform	CC Docket No. 96-262

REPLY TO OPPOSITIONS TO PETITIONS FOR RECONSIDERATION OF THE INDEPENDENT TELEPHONE & TELECOMMUNICATIONS ALLIANCE

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REPLY TO OPPOSITIONS TO PETITIONS FOR RECONSIDERATION OF THE INDEPENDENT TELEPHONE & TELECOMMUNICATIONS ALLIANCE

The Independent Telephone & Telecommunications Alliance ("ITTA")[1] hereby submits its reply to oppositions to petitions for reconsideration filed in the above-captioned docket. As ITTA stated in its comments, ITTA respectfully believes that the Commission in its *Price Cap Order* unlawfully and hastily revised the X-factor without taking into account the statistical variations posed by mid-size LECs.[2] The Commission failed to consider the significant evidence placed in the record that mid-size local exchange carriers ("LECs") do not have the same productivity growth as larger LECs. Therefore, it should immediately suspend operation of the new 6.5 percent X-factor and require mid-size LECs to use a lesser X-factor without sharing. Moreover, the Commission should then initiate a rulemaking to consider the productivity gains

[1] ITTA is an organization of fifteen mid-size telephone companies formed in 1994 to represent the interests of mid-size companies as they are defined in the Telecommunications Act of 1996 – those companies that serve less than two percent of the nation's access lines. The companies currently operate in forty-one states and serve over seven million predominantly rural customers.

[2] Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262, (rel. May 21, 1997) ("*Price Cap Order*").

that reasonably can be expected from the majority of mid-size LECs and establish appropriate X-factors that will allow these carriers to realize the benefits of price cap regulation.[3]

Of those commenting on the petitions for reconsideration, only AT&T argues that the Commission should force all LECs to meet the same productivity growth standard. However, contrary to AT&T's claims, the Commission in 1990 did not establish separate X-factors for mid-size carriers because it lacked a complete record from which to assess these carriers' potential productivity gains, not because more than one X-factor is unsupportable or infeasible. Rather, as ITTA indicated in its comments on the petitions for reconsideration, the Commission indicated it would conduct a future proceeding on this issue. Therefore, to ensure that as many LECs and customers as possible enjoy the benefits of price cap regulation, the Commission should take the actions urged by ITTA and establish X-factors which offer appropriate incentives for mid-size carriers to elect price cap regulation.

I. AT&T MISCHARACTERIZED THE COMMISSION'S DECISION NOT TO ADOPT PRODUCTIVITY FACTORS FOR MID-SIZE COMPANIES.

In its opposition, AT&T claims that in 1990 "the Commission determined that it would not be administratively feasible to establish separate X-factors for the broad classifications of smaller, independent LECs . . . [i]n view of the considerable difficulties of performing

[3] ITTA's request for an interim productivity factor for mid-size price cap companies has no direct bearing on the Commission's proceeding on access charge reform for rate of return LECs. Productivity factors chosen by price cap companies should not predetermine productivity assessments for rate of return companies whose characteristics can vary enormously from those of the largest carriers. The Commission should address the unique attributes of rate of return carriers, including those of mid-size rate of return carriers, in determining appropriate access charge reforms for them.

productivity analyses for the many individual . . . mid-size LECs. . . ."[4] Not only does AT&T completely misstate the Commission's rationale, but the cited Commission order also supports ITTA's position that a further proceeding is warranted.

In 1990, the Commission did not adopt a separate X-factor for mid-size carriers because it did not have an adequate record to evaluate their past and future productivity gains. Indeed the Commission openly acknowledged in the *1990 Price Cap Order* that it lacked the necessary data to create the appropriate X-factor for these carriers. Therein, the Commission considered certain studies submitted by Southern New England Telephone Company ("SNET"), Rochester, and Cincinnati Bell Telephone Company ("CBT") and concluded that it could not "comfortably extend their results to describe the performance of other mid-size carriers . . . [because mid-size LECs] are too diverse in terms of geography, business organization, historical growth rate, customer and resource base and much else. . . ."[5] Rather than deciding that it was infeasible to examine mid-size LEC productivity, the Commission determined that it did not have enough information in 1990 upon which to create an X-factor representative of all mid-size LECs. Accordingly, the Commission deferred its consideration of an appropriate X-factor for these carriers until it could gather further evidence. Specifically, the Commission said:

> [W]ith so many questions still left unanswered in the record, we believe we are well advised to allow the mid-size and small companies the freedom to choose whether or not to participate in price caps at this time instead of attempting,

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[4] AT&T Opposition to Petitions for Reconsideration, CC Docket Nos. 94-1, 96-262 at 6-7 (filed Aug. 18, 1997) ("AT&T Opposition").

[5] Policy and Rules Concerning Rates for Dominant Carriers, 5 FCC Rcd 6786, 6800 (1990) ("*1990 Price Cap Order*").

without a more complete record, to determine one productivity factor for them all.[6]

AT&T's statement that the "study results [of some mid-size carriers] cannot practically serve as a model for uniform treatment of . . . mid-size LECs as a class . . ."[7] is in fact further support for the fact that the Commission needs to examine more data from mid-size LECs before setting an X-factor which applies to them. As the Commission itself noted in the *1990 Price Cap Order:*

> [the data] do provide enough evidence to warrant caution in applying the same high standard to . . . [mid-size] LECs as to the largest eight. . . .[Consequently], to ensure that all LECs and ratepayers will enjoy the benefits of price cap regulation, we will revisit the issue of determining an appropriate productivity offset for small and mid-size LECs.[8]

Therefore, ITTA reiterates its request that the Commission heed its own announced commitment in the *1990 Price Cap Order* to "revisit the issue of determining an appropriate productivity offset for small and mid-size [carriers]"[9] so that these carriers and consumers can "enjoy the benefits of price cap regulation."[10] In the interim, the Commission should immediately suspend

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[6] *1990 Price Cap Order* at 6801.

[7] AT&T Opposition at 6.

[8] *1990 Price Cap Order* at 6799. Although the Commission adopted an incentive regulation plan and limited pricing flexibility for small and mid-size LECs, it never addressed the different factors that affect mid-size LEC productivity. *See In the Matter of Regulatory Reform for Local Exchange Carriers Subject to Rate of Return Regulation,* 8 FCC Rcd 4545 (1993). Nonetheless, the Commission has continued to state that price cap regulation has significant benefits for carriers and their customers, and several mid-size carriers have elected this form of pricing regulation. Therefore, the Commission has an obligation to ensure that mid-size carriers are subject to an X-factor which is based on their realistic productivity capabilities.

[9] *1990 Price Cap Order* at 6799.

[10] *1990 Price Cap Order* at 6790.

application of the 6.5 percent productivity factor to mid-size LECs and permit use of a lesser factor to avoid harming mid-size LEC ratepayers and shareholders.

II. THE FACT THAT THE ELECTION OF PRICE CAP REGULATION IS VOLUNTARY FOR MID-SIZE LECS DOES NOT JUSTIFY APPLICATION OF AN UNREASONABLY HIGH X-FACTOR.

AT&T suggests that the establishment of a single X-factor for all LECs is sustainable because price cap regulation is voluntary for mid-size LECs.[11] As explained below, AT&T is wrong for two reasons. First, price cap regulation is not truly voluntary because the price cap election is irrevocable once made, and the Commission's rules are subject to change after that election is effective. Second, the Commission cannot escape its obligation to adopt reasonable rules based on the evidence simply by making a regulatory scheme voluntary.

A. Independent LECs cannot voluntarily withdraw from price cap regulation.

Although independent LECs may elect price cap regulation, that election is irrevocable, notwithstanding any changes to the price cap regulation rules.[12] Consequently, mid-size LECs, such as SNET which elected price cap regulation in 1991, Aliant which elected price cap regulation in 1993, and Citizens Utilities Company ("Citizens") which elected price cap regulation in 1996, are stuck under a radically altered form of price cap regulation with a vastly different productivity factor that affords them little hope of realizing a reasonable profit.

AT&T argues that Citizens "knew at the time that it was already subject to the same X-factor treatment as the other price cap LECs, that the then-existing X-factor was only 'interim,'

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[11] AT&T Opposition at 5.

and that there was a distinct possibility that a higher X-Factor would be adopted in the pending LEC price cap proceeding."[13] Although Citizens may have been aware of some risk, it cannot have been on reasonable notice that the Commission would both eliminate the use of multiple X-factors and adopt an unreasonable factor that ignored mid-size company data. Based on the Commission's previous decisions, no mid-size LECs that elected price cap regulation prior to the adoption of the *Price Cap Order* could have reasonably predicted that the Commission would make such a substantial change in policy, and these LECs now cannot withdraw from the "voluntary" price cap regulation.[14] Therefore, the Commission should reject AT&T's argument that a single X-factor is reasonable because the regulatory scheme is voluntary for mid-size LECs.

B. Regardless of their voluntary nature, Commission regulations cannot be arbitrary and capricious.

Notwithstanding that independent LECs may choose to become subject to price cap regulation at the outset, the Commission still has a statutory obligation to adopt reasonable rules. The Commission adopted price cap regulation because it was superior to rate of return regulation. Price cap regulation encourages LECs to be more efficient and allows modest price

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(...Continued)
[12] 47 C.F.R. § 61.41(d) (1996).

[13] AT&T Opposition at 9-10.

[14] As ITTA stated in its comments, although CBT elected price cap regulation this year, it states that given the relatively high level of competition already present in its service territory, it had little choice but to enter price cap regulation. As indicated in the next section, the Commission is obligated to make price caps, its preferred method of rate regulation, reasonable for CBT and other companies that may need to adopt price caps in the future.

flexibility that benefits both ratepayers and the companies.[15] This conclusion was reaffirmed in its recent *Price Cap Order*.[16] In light of these clear benefits, the Commission should be encouraging mid-size carriers to elect price cap regulation. Instead, the Commission ignored evidence of mid-size LEC productivity and adopted a productivity factor applicable to all LECs that will preclude most mid-size LECs from benefiting from price cap regulation.

As evidence proffered from mid-size carriers clearly indicates, it is unlikely that these LECs could achieve a productivity growth rate of 6.5 percent in any year in the foreseeable future.[17] For example, SNET has submitted to the Commission compelling data as to the impact a 6.5 percent X-factor will have on its annual interstate rates of return over the next five years based on the fact that its estimated total productivity growth from 1985 to 1992 was an average of 1.9 percent.[18] Based on SNET's analysis, SNET's interstate rate of return would be 11.0 percent the first year, 9.2 percent the second year, 8.1 percent the third year, 6.9 percent the fourth year, and 5.6 percent the fifth year.[19] Under such a scenario, SNET and any other

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[15] *1990 Price Cap Order* at 6788.

[16] *Price Cap Order* at 4-5.

[17] ITTA incorporates by reference SNET's Petition for Waiver and/or Amendment of Part 61 of the Commission's Rules Establishing an X-Factor of 6.5% (filed Aug. 13, 1997) ("SNET's Waiver Petition"). SNET's Waiver Petition presents compelling evidence of the negative impact a 6.5 productivity factor will have on a mid-size carrier. ITTA avers that SNET's experience is representative of many mid-size LECs. Accordingly, the Commission should pay close attention to SNET's data. ITTA also incorporates by reference the Comments of the Cincinnati Bell Telephone Company (filed Aug. 15, 1997) which support Citizens Utilities Company Emergency Petition for Waiver of the New X-Factor Rules filed with the Commission on July 14, 1997.

[18] SNET's Waiver Petition, Declaration of David F. Clark at 4.

[19] *Id.* at 4.

similarly situated mid-size LECs will suffer repeated, severe economic losses and have to employ, on a yearly basis, the low-end adjustment mechanism[20] – a mechanism that has been designed as only a fail-safe backstop for price cap LECs.[21] Similarly, Citizens has projected that under the 6.5 percent productivity factor, its rate of return would be 10.74 percent for July 1997 through December 1997 and 10.24 percent for 1998[22] – returns which clearly do not allow this carrier to reap the benefits of price cap regulation, let alone earn the 11.25 percent rate of return that the Commission has previously established as reasonable.

As explained above, these and other carriers did not elect price cap regulation with any reasonable expectation that the Commission would create such an unattainable X-factor. By subjecting these carriers to a 6.5 percent X-factor – even when the evidence clearly demonstrates that this is not a reasonable estimate of achievable growth – the Commission has substantially undermined its fundamental goal in establishing price cap regulation which was to ensure that

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[20] Based on SNET's data, even under lower productivity factors, namely 3.3 and 4.0 percent, SNET was unable to achieve a rate of return of 12.25 percent which would have subjected it to the sharing zone. Under a 3.3 percent productivity factor, SNET's rate of return was 8.56 in 1991, 12.06 percent in 1992 (reflecting the low-end adjustment), 11.52 percent in 1993 and 11.34 percent in 1994. Under the 4.0 percent productivity factor, SNET's rate of return was 11.58 percent in 1995 and 11.49 percent in 1996. *See* SNET's Waiver Petition at 6. Based on these numbers, it is illogical for the Commission to conclude that SNET or any other similarly situated carrier could survive for any significant period of time with the application of a 6.5 percent productivity factor. Mid-size carriers simply lack the economies of scale and scope possessed by the larger LECs.

[21] *See 1990 Price Cap Order* at 6804; *Price Cap Order*, ¶ 160. *See also* Comments of ITTA, CC Dockets 94-1, 96-262 at 5 (filed Aug. 18, 1997).

[22] Petition for Reconsideration of Fourth Report and Order, Declaration of Mark Shine, CC Docket Nos. 94-1, 96-262 at 7 (filed July 11, 1997).

"both carriers and customers will be better off."[23] Thus, contrary to AT&T's assertions,[24] simply having the option of electing price cap regulation is not justification for the Commission to ignore completely mid-size LEC data in crafting an X-factor applicable to these carriers.

Concededly, SNET's, CBT's and Citizens' evidence vary and are not necessarily representative of all mid-size LECs. However, the evidence irrefutably establishes that a 6.5 percent X-factor is too high for these carriers and lends support to ITTA's contention that it will likely be too high for other mid-size carriers as well. Accordingly, the Commission should initiate a proceeding to ascertain whether the experiences of SNET, CBT, and Citizens are representative of mid-size LECs as a whole, regardless of whether such regulation is voluntary.

In addition, Bell Atlantic wrongly asserts that larger firms' rates of growth in productivity would be less than smaller firms.'[25] As support for its claim, Bell Atlantic cites its economist, Dr. Christensen, who states that smaller firms are "able to exploit higher returns to scale than larger firms."[26] Dr. Christensen, however, ignores the fundamental differences in scale and scope between large and mid-size LECs – differences which dictate treating elective price cap LECs differently. The vastly greater scale of the largest LECs afford them an opportunity to cut costs that smaller mid-size LECs do not have. Moreover, the larger companies' greater scope gives them a greater opportunity to diversify their revenue base and maximize their productivity

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[23] *1990 Price Cap Order* at 6790.

[24] AT&T Opposition at 7-12.

[25] Opposition of Bell Atlantic to Petitions for Reconsideration of Price Cap Order, CC Docket Nos. 94-1, 96-262, 91-213 at 10 (filed Aug. 18, 1997) ("Bell Atlantic Opposition").

[26] *Id.* at 10.

growth. In evaluating company-wide productivity estimates, Dr. Christensen also disregards mid-size LECs' inability to offset state-wide or regional economic trends that the largest LECs can compensate for with their multi-state regional service territories. SNET and Aliant, as single state ILECs, are not able to benefit from geographic and regional diversification enjoyed by the largest LECs.

Mid-size companies clearly face numerous market and regulatory factors not faced by larger companies that impact negatively on smaller LECs' productivity. These carriers typically serve more rural areas which have a significantly slower growth rate than the urban areas served by the largest carriers. Moreover, smaller carriers are more dependent on access revenues and universal service support than are the largest carriers and thus will have their productivity disproportionately affected by the regulatory changes proposed by the Commission.

III. CONCLUSION

For the foregoing reasons, the Commission should reject AT&T's arguments and reconsider its decision to adopt a 6.5 percent X-factor applicable to all price cap LECs.

Respectfully submitted,

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September 3, 1997

CERTIFICATE OF SERVICE

I, Jacquelyn Martin, hereby certify that on this 3rd day of September, 1997, I caused copies of the foregoing "Reply to Oppositions to Petitions for Reconsideration of the Independent Telephone & Telecommunications Alliance" to be mailed via first-class postage prepaid mail to the following:

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